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Department of Defense Management of Unobligated Funds for Acquisition Programs

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On September 10, 2012, the Under Secretary of Defense (Comptroller) and the Under Secretary of Defense for Acquisition, Technology, and Logistics signed a joint memorandum calling for a change in the management of unobligated funds for acquisition programs. The memo was an attempt to stop the rush to obligate funds by the end of the current fiscal year in order to avoid reduced allocations in the next fiscal year. The memo identified six tenets for adoption throughout the Department of Defense (DoD). Included are tenets to reward acquisition program managers for returning unobligated funds and not to reduce future year program budgets just because current year obligation rates are lower than established benchmarks. The 2014 Annual Report on the Performance of the Defense Acquisition System (OUSD[AT&L], 2014) indicated that the DoD was continuing the effort to change the acquisition culture from focusing on obligation rates. This research analyzes financial obligation rates for acquisition programs and acquisition program contract awards made in the last quarter of the fiscal year to determine if this policy memo has resulted in any change in behavior toward year-end spending. Research finds that the policy memo has not yet had an effect on behavior and that it has not been incorporated into DoD policy regulations.

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Department of Defense Management of Unobligated Funds for Acquisition Programs

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Abstract

On September 10, 2012, the Under Secretary of Defense (Comptroller) and the Under Secretary of Defense for Acquisition, Technology, and Logistics signed a joint memorandum calling for a change in the management of unobligated funds for acquisition programs. The memo was an attempt to stop the rush to obligate funds by the end of the current fiscal year in order to avoid reduced allocations in the next fiscal year. The memo identified six tenets for adoption throughout the Department of Defense (DoD). Included are tenets to reward acquisition program managers for returning unobligated funds and not to reduce future year program budgets just because current year obligation rates are lower than established benchmarks. The *2014 Annual Report on the Performance of the Defense Acquisition System* (OUSD[AT&L], 2014) indicated that the DoD was continuing the effort to change the acquisition culture from focusing on obligation rates. This research analyzes financial obligation rates for acquisition programs and acquisition program contract awards made in the last quarter of the fiscal year to determine if this policy memo has resulted in any change in behavior toward year-end spending. Research finds that the policy memo has not yet had an effect on behavior and that it has not been incorporated into DoD policy regulations.

Background

Unobligated balances are amounts of budget authority available to acquisition program managers (PMs) that have not yet been obligated on contracts. Each year, PMs must plan for obligating a high percentage of their available budget authority or risk losing the unobligated balance to a higher priority program. The process for repurposing budget authority from one program to another or from one appropriation account to another is termed reprogramming, and is done by the component comptroller and the Under Secretary of Defense (Comptroller). There are three primary means of *reprogramming* that could be used to repurpose unobligated balances: below threshold, congressional notification letter, and prior approval.

Budget authority is provided to the Department of Defense (DoD) by three annual appropriation acts: the Defense Appropriation Act; the Military Construction, Veterans Affairs and Other Related Agencies Appropriation Act; and the Energy and Water Development Appropriation Act. Once these acts are signed by the President, the DoD can request apportionment of the budget authority from the Office of Management and Budget (OMB). The OMB usually apportions the annual amount of budget authority for the procurement appropriation accounts and either annual or quarterly amounts for Research, Development, Test, and Evaluation (RDT&E) appropriation accounts. However, the president may temporarily impound budget authority for programs with technical problems and may request rescission of budget authority for programs that have been canceled or changed significantly. In addition, the OMB may reduce the apportioned budget authority to pay for a program that the Congress authorized, but did not appropriate any budget authority for in one of the appropriations acts. For example, each year the Congress authorizes the Small

Business Innovative Research (SBIR) program, but directs the DoD to fund the SBIR program with a general reduction in budget authority from all RDT&E-funded programs.

In anticipation of the apportionment of budget authority, all PMs are to submit obligation and expenditure plans (also termed spending plans) to their component comptroller. These plans serve as a month-by-month forecast, through the entire fiscal year, of when budget authority will be obligated on contract and when the obligated amounts will be liquidated by expenditures made to pay defense contractors. It is important for the PM to prepare realistic spending plans. For new start programs, obligation of budget authority should not be planned for the first quarter of the fiscal year. Recent history has shown that the DoD operates in the first quarter of most fiscal years under stop-gap funding called a *continuing resolution*. Since the annual appropriation bills are still in work, budget authority for new starts has not yet been determined or appropriated. Therefore, obligations for new starts cannot be made while operating under a continuing resolution. PMs are also cautioned not to plan for the obligation of large amounts of budget authority in the fourth quarter of the fiscal year. This is because the appropriation acts usually restrict obligations in the last two months of the fiscal year to no more than 20% of the appropriated amount. The purpose of this constraint is to force planning and avoid rushing into contracts at the end of the fiscal year just to show that fund obligations have been made.

In the March timeframe of each fiscal year, the component comptroller usually conducts a mid-year review of the status of obligations and expenditures by program (see Figure 1).

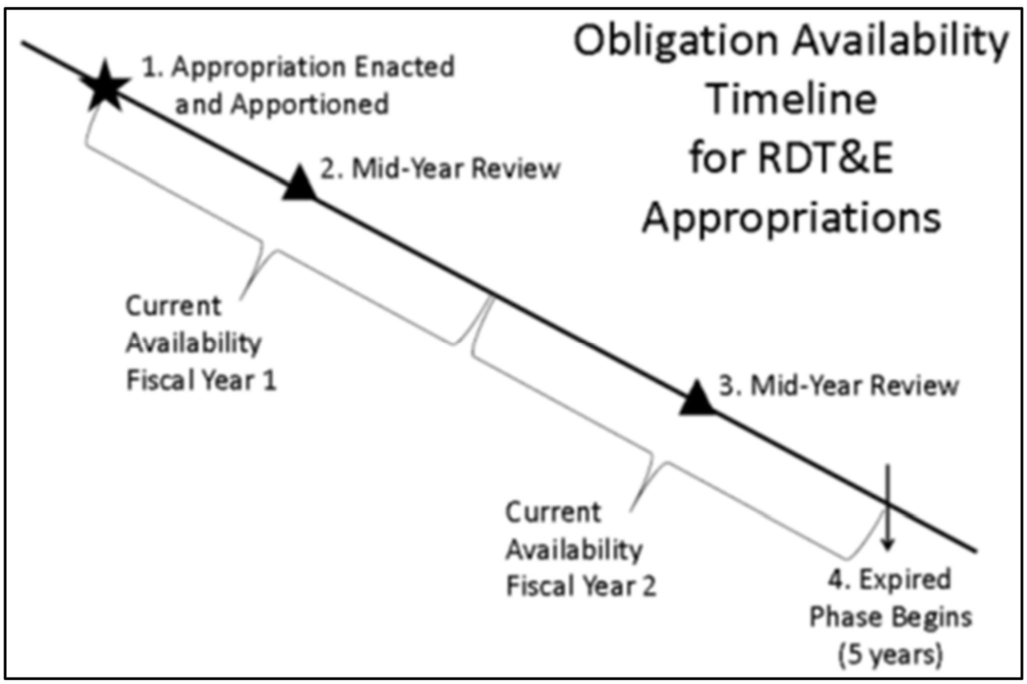

Figure 1. Obligation Availability Timeline for RDT&E Appropriations

The purpose of this review is to identify programs that have deviated from their spending plans and have large unobligated balances of budget authority (i.e., low obligations) or large unliquidated obligations (i.e., low expenditures). About two years earlier, in the budget formulation process, the PM should have asked for RDT&E funds to cover all contractor-incurred costs in the fiscal year. This is in accordance with the incremental funding policy that applies to all RDT&E appropriation accounts (OUSD[AT&L],

2015). Similarly, the PMs should have requested budgets to fully fund complete, militarily-useable end items in the fiscal year of contract award for those end items. This is in accordance with the full funding policy that applies to all procurement accounts, including Ship Building and Conversion, Navy, and to the Military Construction appropriation accounts (OUSD[AT&L], 2015). If budget authority is not being placed on contract in the year for which it was requested, the comptroller could decide to reprogram some or all of the unobligated amounts to a higher priority program. In Pentagon parlance, the under-obligated program could become a bill payer for a higher priority program.

If the PM successfully defends the under-obligated program at the mid-year review, the pressure is on to get the majority of the budget authority obligated by September 30, the end of the fiscal year. If the funds are not obligated by the end of the first fiscal year of availability, then the comptroller has yet another opportunity to reduce the program's future budget request during the Budgeting phase of the Planning, Programming, Budgeting and Execution (PPBE) process. During this budget review, which occurs in the August to October timeframe, the Under Secretary of Defense (Comptroller) and OMB analysts test the Budget Estimate Submissions (BES) submitted by the components to ensure that each program's budget request is defendable before the Congress. As a result of this PPBE process budget review, the analysts will sometimes find that a program is forward financed. That is, compared to its needs, the program has too much current and carried-over budget authority. If this is the case, the analysts will recommend that the requested future budget be reduced accordingly.

The tensions created by the mid-year and PPBE budget reviews can cause the PM to behave in different ways. First, as discussed above, the PM might decide to move quickly to get the budget authority on contract, regardless of how bad the business deal that is for the taxpayer. Obviously, this behavior is irresponsible, but logical in terms of retaining current budget authority and stabilizing future budget requests. Second, the PM might agree with the comptroller's decision to reprogram unobligated funds to a higher priority program, provided that a promise is made to replace the budget authority removed with future funds, escalated as appropriate to account for future inflation and outlay rates. Finally, the PM might decide to fight any action by the comptroller to remove funds by sharply rebutting the action. This approach would require that a reclama be prepared, citing operational mission and supportability impacts to the user (warfighter) and business impacts that affect the execution of the program. If successful with the reclama, the PM has more time in which to negotiate a good deal before obligating the budget authority on contract.

Having observed all of these behaviors over many years, in September 2012, the Under Secretary of Defense (Comptroller), the Honorable Robert F. Hale, and the Under Secretary of Defense for Acquisition, Technology, and Logistics, the Honorable Frank Kendall III, signed a joint memorandum (copy in appendix) that outlined six new tenets for dealing with unobligated balances during budget reviews:

1. Taxpayer funds should be obligated and ultimately expended only in the taxpayers' interest and if best value is received for the money in support of the Warfighter.
2. While they can be useful indicators, obligation rates slower than established benchmarks should not be the determinative measuring stick for program execution and must not be regarded as a failure.
3. Late obligation of funds should not be presumed to imply that the funds are not needed or that future budgets should be reduced unless there is other evidence to support that conclusion.

4. Providing savings to the organization, military service, or DOD component as early in the fiscal year as possible should be encouraged and rewarded, professionally and visibly.
5. Savings will not be reallocated at any higher DOD level than necessary to fulfill shortfalls in priority requirements.
6. Managers who release unobligated funds to higher priorities will not automatically be penalized in their next year's budget with a lower allocation and may be candidates for additional funding to offset prior year reductions. (OUSD[AT&L] & OUSD[C], 2012)

The two under secretaries asked that acquisition and financial managers throughout the DoD follow these tenets when reviewing programs not meeting established obligation rates. However, as of this writing, the policy memorandum has not been incorporated into any DoD regulations (M. Engelking, personal communication, February 5, 2015).[1]

Before incorporating these tenets into DoD regulations, data-driven research should be conducted to answer three important questions:

1. What are the recent obligation rates, and how big are unobligated balances in the RDT&E and procurement accounts?
2. What is happening to unobligated balances at the end of obligation availability? Are PMs rushing into poor contracts just to prevent funds from being taken away, or to prevent reductions to future budgets?
3. What recent legislation has been introduced and/or enacted by the Congress on the subject of unobligated balances and meeting obligation benchmarks?

The balance of this paper provides data-driven research that answers these questions and can be used to guide the implementation of policy guidance on the management of unobligated balances.

Recent Trends in Obligation Rates and Unobligated Balances

With the rollout of the president's budget in February of each year, the Under Secretary of Defense (Comptroller) presents a budget briefing for the news media and makes available financial summary tables. These tables contain historical and forecasted obligation rates for the RDT&E and procurement appropriation accounts. These rates, rolled to the DoD level and representing obligations at the end of the first year of obligation availability, were extracted and plotted in Figure 2.

[1] Email, dated February 5, 2015, regarding implementation of obligation rates tenets, follows: "Volume 3, Chapter 8 [DoD 7000.14-R, Financial Management Regulation] was revised and forwarded to the Office of Legal Counsel for coordination a few months ago. It was revised by an action officer who has since left OUSD(C). I am now responsible for the chapter. I reviewed my predecessor's files related to this chapter and did not locate a copy of the memorandum you provided. I also scanned the document to see if it addressed this issue. Unfortunately, the revised version does not address it. I will request that the chapter be returned to me for revision. It will be scheduled to be published by the end of the fiscal year. Thank you for bringing this to our attention. Maryla Engelking, CPA, CGFM, MBA, Senior Staff Accountant, Office of the Under Secretary of Defense (Comptroller), Financial Improvement and Audit Readiness (FIAR), 703-571-1657, maryla.e.engelking.civ@mail.mil."

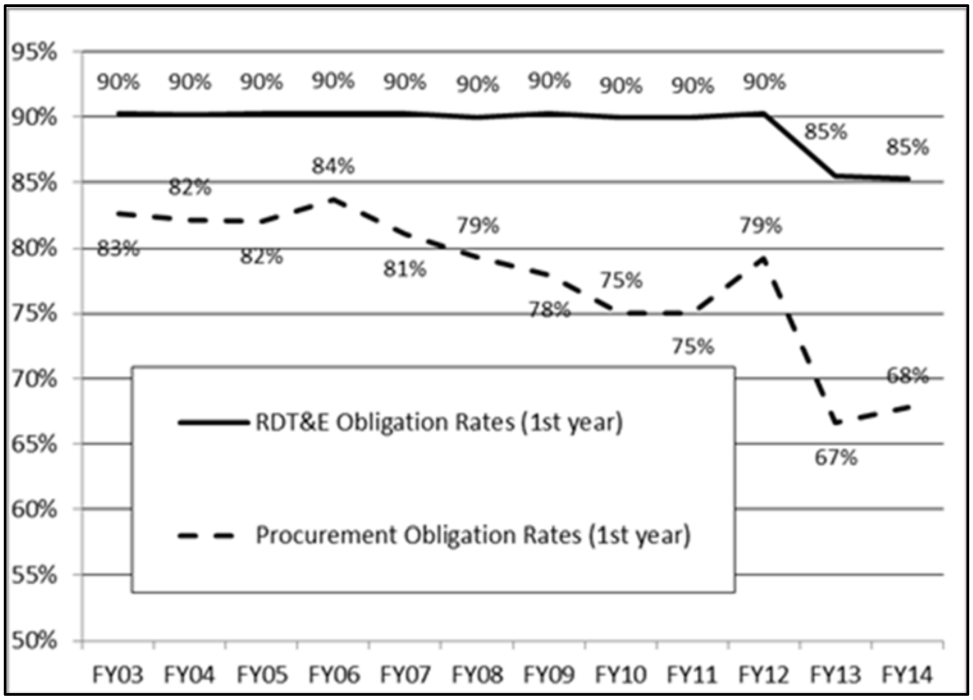

Figure 2. DoD Composite Obligation Rates, End of First Year of Obligation Availability, for RDT&E and Procurement Appropriations
(OUSD[C], 2015b)

From FY 2003 to FY 2012, RDT&E obligation rates held steady at 90%. This percentage is in accordance with historical DoD and Service/Component benchmarks for RDT&E obligations at the end of the first year of funds availability. However, overall RDT&E obligation rates dipped to 85% in FY 2013 and FY 2014. Perhaps this recent dip reflects implementation of the joint memo on obligation rate tenets, which was just discussed. However, if that were the case, one would expect to see a similar trend in the procurement accounts, which is not the case (see discussion that follows).

From FY 2003 to FY 2007, procurement obligation rates hover between 80% and 85%. This percentage is in accordance with historical DoD and Service/Component benchmarks for procurement obligations at the end of the first year of funds availability. However, procurement obligation rates begin to dip below 80% in FY 2008 and get as low as 67% and 68% in FY 2013 and FY 2014, respectively.

The financial summary tables provided with the annual president's budget rollout briefing also contain unobligated balances, brought forward from the previous fiscal year. These balances were extracted from the tables and plotted on bar graphs for RDT&E (Figure 3) and Procurement (Figure 4). In each figure, the bottom solid bar represents the budget authority appropriated in that particular fiscal year. The shaded tip of the bar represents the carryover of unobligated budget authority from the previous year. Together, the appropriated budget authority and the carryover funds can be considered a rough approximation of the total obligation authority available in any particular year.

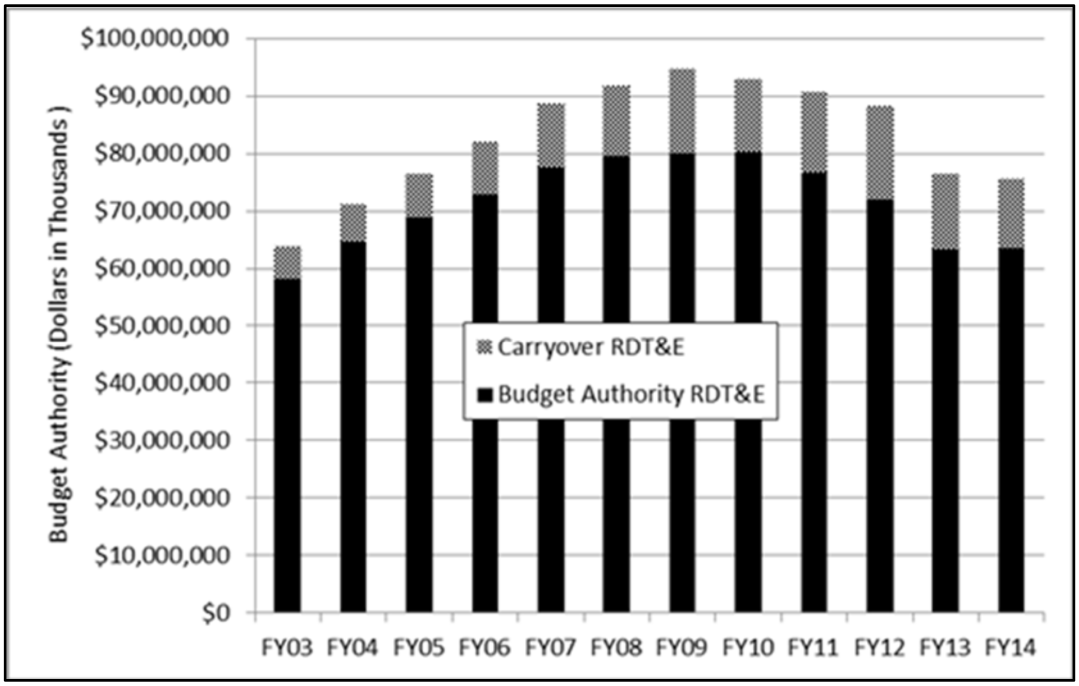

Figure 3. Unobligated RDT&E Appropriation Balances (Carryover) From Previous Fiscal Year
(OUSD[C], 2015b)

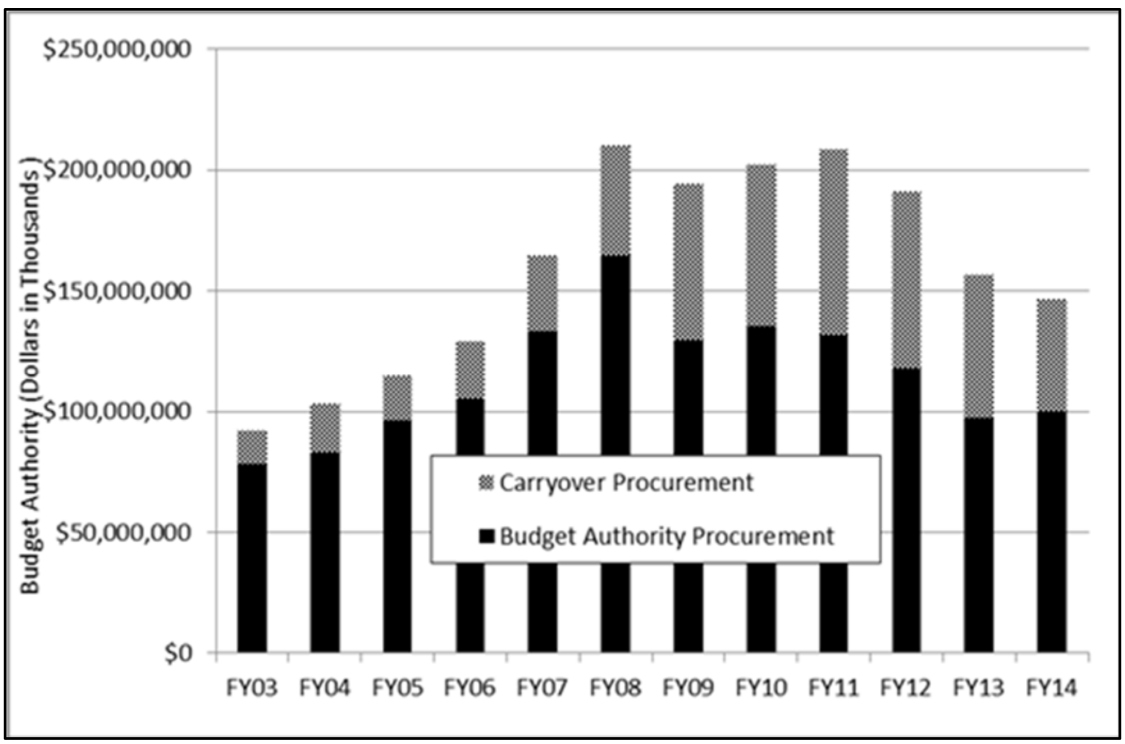

Figure 4. Unobligated Procurement Appropriation Balances (Carryover) From Previous Fiscal Year
(OUSD[C], 2015b)

In the DoD's four RDT&E accounts, carryover as a percentage of total obligation authority has nearly doubled from 8.8% in FY 2003 to 15.9% in FY 2014. In the DoD's procurement accounts, carryover as a percentage of total obligation authority has more than doubled from 15% in FY 2003 to 31.6% in FY 2014. Because the increases in unobligated balances began at least nine years earlier, the September 2012 joint memo on obligation rate tenets did not cause these carryover increases. Analysis of the Service/Component unobligated carryover indicates that

> from analyzing the trends in obligation rates and carryover data, the answer to the first important question becomes clear. Obligations rates in both the RDT&E and procurement accounts are falling, with procurement obligation rates falling at further than RDT&E obligation rates. Also, for both RDT&E and procurement, carryover balances have more than doubled as a percentage of total obligation authority. As will be seen later, lower obligation rates and higher carryover amounts make DOD appear to be *forward financed* and expose future budgets to higher risks of reduction during the congressional enactment process.

Disposition of Unobligated Balances

At the mid-year review, or whenever a higher priority need arises, reprogramming provides some flexibility for the DoD to repurpose budget authority. Prior approval reprogramming, requiring approval of the Congressional Defense Committees before implementation, is used when budget authority changes from one appropriation to another. However, below certain dollar and percentage thresholds, budget authority can be moved from one RDT&E program element to another or from one procurement line item to another. Such below-threshold reprogramming (BTR) can be accomplished by the Service/Component and DoD comptrollers and is reported to the Congress quarterly on DD 1416 Program Reports. The Under Secretary of Defense (Comptroller) website contains only a few years of data on recent BTR actions. This data is plotted, by the four DoD RDT&E accounts, in Figures 5 and 6.

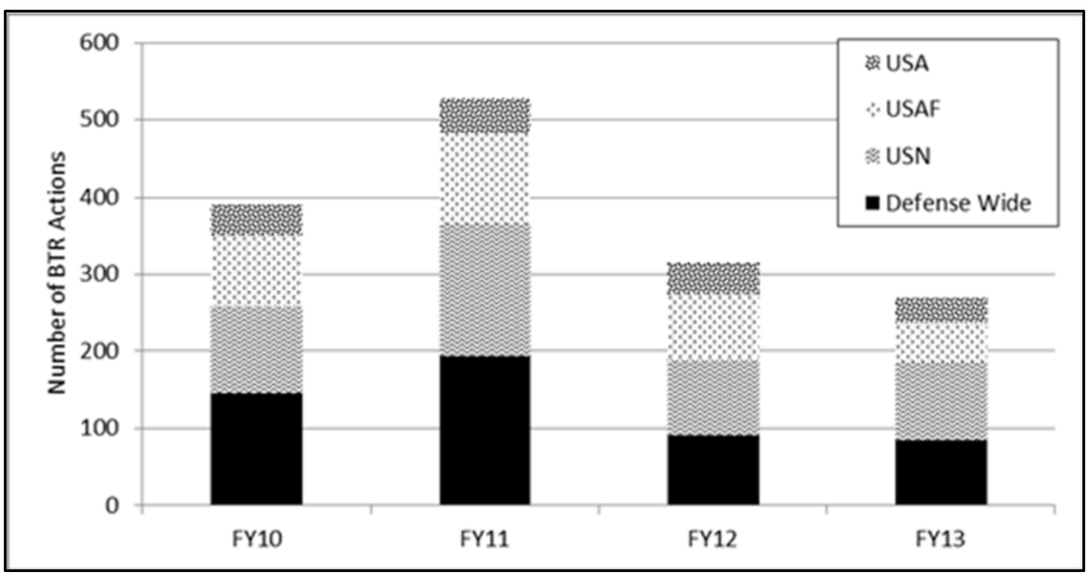

Figure 5. Number of Below-Threshold Reprogramming Actions, RDT&E Appropriation Accounts
(OUSD[C], 2014)

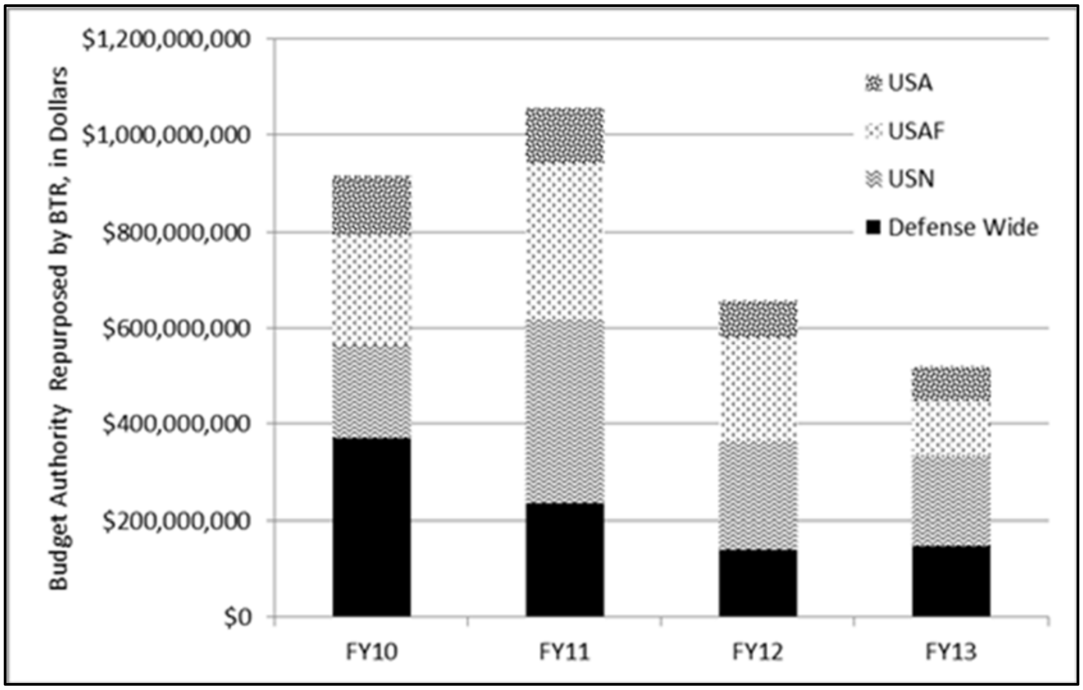

Figure 6. Total Budget Authority Repurposed by Below-Threshold Reprogramming Actions, RDT&E Appropriation Accounts
(OUSD[C], 2014)

Figures 5 and 6 reveal that, at least for two years (FY 2011 and FY 2012), the number of BTR actions and the budget authority repurposed through BTR actions declined in all four of the RDT&E appropriation accounts. One might conclude from this data that the policy memo on obligation rate tenets has had an effect. Fewer BTR actions might mean that fewer acquisition programs are being tapped as *bill payers* for higher priorities. However, more research is needed into the reasons for the BTR actions and the reason for the decline in the number of BTR actions/amounts. Only the 2010 DD 1416 Quarterly Reports of Programs identify reason codes associated with the BTR actions. After 2010, the codes and hyperlinks to any amplifying information are missing. Help from the Office of the Under Secretary of Defense (Comptroller) is needed to provide this missing information.

Contract awards made late in the fiscal year, particularly in the fourth quarter, may also be an indicator of the effect of the policy memo on obligation rate tenets. PMs and business financial managers (BFMs) are taught not to plan for obligations of funds in the fourth quarter of any fiscal year. One reason for this is because the appropriation acts usually restrict obligations in the last two months of the fiscal year to no more than 20% of the appropriated amount. Another reason for not planning fourth quarter contract awards is that program schedules and contract awards often slip. If program schedule slippage does occur, it is easy for the comptroller to recommend that contract awards scheduled for the fourth quarter be rescheduled into the next fiscal year.

The Defense Acquisition Management Information Retrieval (DAMIR) has a database of 421 large active contracts from Major Defense Acquisition Program and Major Automated Information Systems. The award dates of these contracts are plotted in the bar chart in Figure 7.

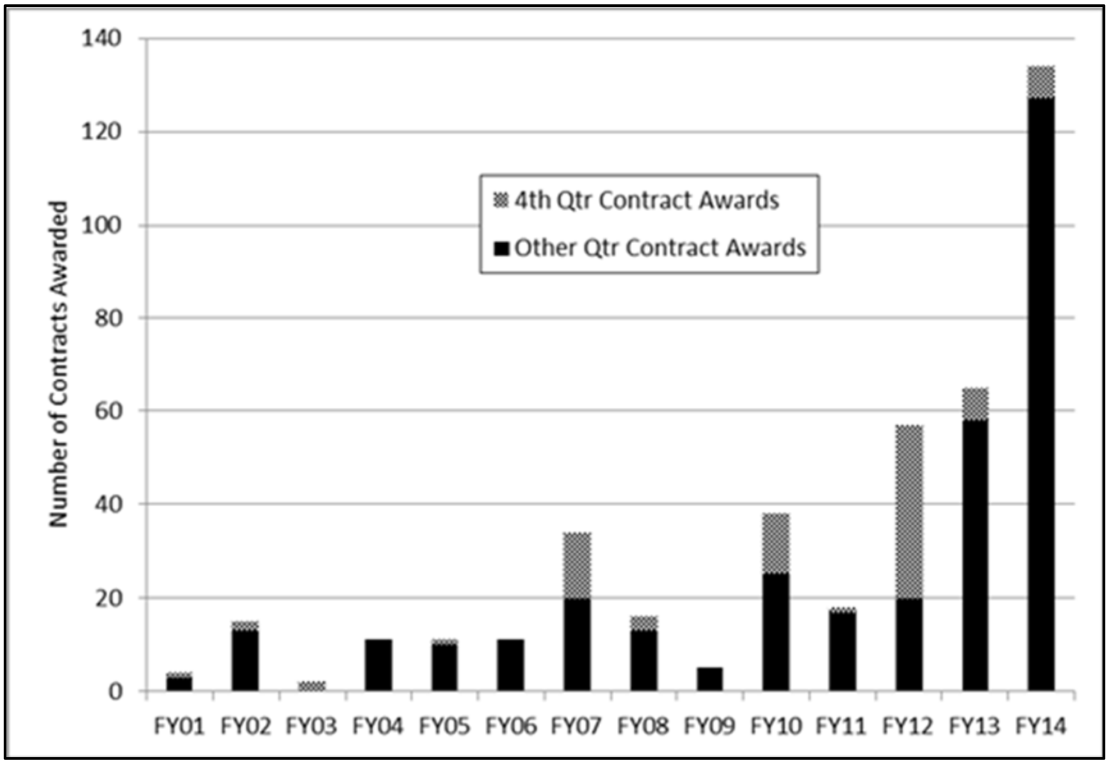

Figure 7. Fourth Quarter Contract Awards Compared to Contracts Awarded in Other Quarters
(OUSD[AT&L], 2015)

Although PMs and BFMs are taught to avoid scheduling contract awards in the fourth quarter of the fiscal year, the data in Figure 5 shows that a number of contract awards are, in fact, taking place in the fourth quarter. If unobligated funds can be carried over, because obligation benchmarks have been relaxed, perhaps the PMs are attempting to commit those funds before the end of the fiscal year when the funds' period of obligation availability ends. Unfortunately, the data provided in the DAMIR data used in Figure 5 does not reveal or imply any causal relationship between the fourth quarter contract awards and the policy memo on obligation rate tenets. More research into the reason for fourth quarter contract awards is needed.

Recent Legislation on Unobligated Balances and Benchmarks

The annual Defense Appropriations Act consistently includes this language: "No more than 20 percent of the appropriations in this Act which are limited for obligation during the current fiscal year shall be obligated during the last 2 months of the fiscal year" (Department of Defense Appropriations Act, 2015). This language is supposed to preclude a rush to award contracts, just to lower unobligated balances at the end of the fiscal year.

Over the past several years, the Congress has marked down the DoD portion of the president's budget request when large unobligated balances exist. For example, in the DoD Appropriations Act for 2015, the Congress cut $1.76 billion out of the request due to unobligated balances left over from earlier budget years (Congressional Research Service, 2015). Enacting the FY 2012 Defense Appropriations Act, the Congress cut $2.66 billion from the president's budget request with the rationale that that unobligated balances could be used in lieu of new budget authority. (Congressional Research Service, 2012). Of course,

the problem is that new budget authority has longer periods of availability than old unobligated funds. What might appear to be a rational reduction in new budget authority is really placing a more onerous task on financial managers and contracting officers who must now work more quickly to get the old funds obligated on contracts.

Finally, in the case of recent sequestration cuts, there is a somewhat ironic advantage to having large unobligated balances. For example, in FY 2013, sequestration cuts to DoD investment accounts resulted in an average 11.2% reduction across old unobligated funds. However, the more current FY 2013 budget authority, which has a longer period of obligation availability than old funds, was somewhat preserved, suffering an average sequestration cut of only 5.2% (Congressional Research Service, 2014).

Conclusion

Given the data-driven research just provided, the Under Secretary of Defense (Comptroller) and the Under Secretary of Defense for Acquisition, Technology, and Logistics should exercise caution in implementing their joint policy memorandum that outlined obligation rate tenets. First, recent trends in obligation rates have shown that by the end of the first year of obligation availability, obligation rates for both the RDT&E and the procurement appropriations have dropped below historical norms. Second, this drop in obligation rates has resulted in the carryover of a greater percentage of funds each budget year. Motivated by austere times, the Congress continues to cut the DoD portion of the president's budget request by amounts nearly equal to the carryover amounts.

Contract awards in the fourth quarter of the fiscal year may indicate that there is still a rush to place funds on contract before the end of obligation availability. While some of these rushed contract awards may represent a good business deal, some of the fourth quarter awards probably waste taxpayer dollars. However, more research is needed into the reasons for fourth quarter contract awards. The number of reprogramming actions and associated amounts of repurposed budget authority may also be an indicator of behavior toward unobligated balances. However, reason codes are missing from recent BTR data, so it was not possible in this research effort to link any change in BTR actions or BTR amounts to the policy memo on obligation rate tenets.

Perhaps the Services/Components are following the joint policy memorandum on obligation rate tenets even though the policy has not been incorporated into any DoD regulation. This may be a causal reason for lower obligation rates and increasing carryover amounts in the RDT&E appropriation accounts. But, why did obligation rates dip five years earlier in the procurement appropriation accounts? Once again, more research is needed.

Whether or not there is any linkage between the data revealed by this research and the joint policy on obligation rate tenets, the Congressional Defense Committees need to be informed of the policy and asked not to decrement RDT&E and procurement accounts without first assessing why large unobligated balances exist for some acquisition programs. Of course the DoD will have to provide more detail on carryover amounts, perhaps as part of budget justification materials, to convince the Congressional Defense Committees that the carryover of funds is legitimate and necessary for program success.

It would be prudent for the Under Secretary of Defense (Comptroller) and the Under Secretary of Defense for Acquisition, Technology, and Logistics to get the Congress to agree with the policy memo on obligation rate tenets before incorporating those tenets into DoD regulations. And, it appears that such a dialog has now begun. In response to a request from the U.S. Senate for ideas on the subject of Defense Acquisition Reform, the

Honorable Frank Kendall III, Under Secretary of Defense for Acquisition, Technology, and Logistics, wrote

> For 4 years I have worked to train and encourage our acquisition workforce to take time to get good business deals for the Taxpayer by conducting appropriate upfront analysis, and by doing the systems engineering and planning necessary for successful programs. At the same time our program managers live in a world in which they are punished for not obligating the funds they control on set schedules. We should have realistic plans to execute our budgets, but when a manager has sound reasons to delay obligation, that behavior should not be punished. I have worked with the Under Secretary of Defense (Comptroller) to provide a more balanced approach to how we handle obligation reviews within the Department, and we would like to work closely with Congress in striking a similar balance on this matter. (Permanent Subcommittee on Investigations, 2014, p. 115)

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Appendix

OFFICE OF THE SECRETARY OF DEFENSE
1000 DEFENSE PENTAGON
WASHINGTON, DC 20301-1000

SEP 1 0 2012

MEMORANDUM FOR: SEE DISTRIBUTION

SUBJECT: Department of Defense Management of Unobligated Funds; Obligation Rate Tenets

The purpose of this memorandum is to address a long-standing Department of Defense (DoD) problem regarding the way we manage unobligated funds.

The acquisition community, starting with the Under Secretary for Acquisition, Technology and Logistics, has been stressing the importance of spending money in a way that maximizes the value the Department and the taxpayer receive. Our policy encourages managers to obligate funds when a satisfactory contract is negotiated or when they can be used most efficiently. The financial management community, starting with the Under Secretary of Defense (Comptroller), has primarily been measuring program execution against established obligation benchmarks as the basis for sourcing funds for higher Department priorities. Obviously, both goals – effective acquisition practices and use of resources for the highest Department priorities – have merit. We must strive to meet both goals while also taking into account two types of risks.

First, there are risks in focusing on obligation benchmarks. The threat that funding will be taken away or that future budgets can be reduced unless funds are obligated on schedule is a strong and perverse motivator. We risk creating incentives to enter into quick but poor business deals or to expend funds primarily to avoid reductions in future budget years. We need to rethink how we approach managing mid-year and end-of-year obligations and to change the types of behavior we reward or punish. We will continue to hold our Program/contracts teams accountable for executing to their planned schedules, but we have to stop measuring only benchmark execution as the dispositive method of determining whether funds are available for higher priorities. Such benchmarks should only be a place to start a discussion of obligation management, not a place to end that discussion.

But there are also risks in ignoring obligation benchmarks. For the past several years, Congress has used unobligated balances as a means to reduce our budgets. To avoid this result, we need to stop thinking of the transfer of funds to higher priorities as something we must avoid at any cost. We need to build a culture where maximizing the Department's buying power for both the taxpayer and the Warfighter as well as meeting the Department's highest priorities become the primary driving force behind obligation decisions. Often, these funds can be better employed elsewhere and individual programs should not fight to avoid "losing" the unobligated funds.

We believe that the following tenets should be adopted and enforced at all levels of the chain of command, and by acquisition and financial managers throughout the Department:

1. Taxpayer funds should be obligated and ultimately expended only in the taxpayers' interest and if best value is received for the money in support of the Warfighter.

2. While they can be useful indicators, obligation rates slower than established benchmarks should not be the determinative measuring stick for program execution and must not be regarded as a failure.

3. Late obligation of funds should not be presumed to imply that the funds are not needed or that future budgets should be reduced unless there is other evidence to support that conclusion.

4. Providing savings to the organization, military service, or DoD component as early in the fiscal year as possible should be encouraged and rewarded, professionally and visibly.

5. Savings will not be reallocated at any higher DoD level than necessary to fulfill shortfalls in priority requirements.

6. Managers who release unobligated funds to higher priorities will not automatically be penalized in their next year's budget with a lower allocation and may be candidates for additional funding to offset prior year reductions.

This year, the undersigned will begin implementation of a deliberate process by reviewing MDAPs and other programs that have not obligated funds consistent with normal obligation rates. We will do this together, co-led by officials designated by the undersigned, and we will follow the tenets we have listed. We will start with guidelines for the review, which will be issued soon.

We urge all financial and acquisition managers and the chain of command in each Component to follow the same guiding principles and to implement similar reviews within their organizations.

Robert F. Hale
Under Secretary of Defense
(Comptroller)

Frank Kendall
Under Secretary of Defense for
Acquisition, Technology and Logistics

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